

## **The Uruguayan tax reform of 2006: why didn't it fail?**

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### **RESUMEN**

El artículo analiza los factores por los que la Reforma Tributaria uruguaya de 2006 no abortó durante su gestación, aprobación parlamentaria e implementación, a pesar de haber despertado resistencias de una mitad del electorado y la oposición partidaria. Se muestra que esas mismas resistencias tienen carácter paradójico, teniendo en cuenta que la reforma introdujo medidas que ocasionaron más ganancias que pérdidas a una mayoría absoluta de votantes. Los pasos deliberados o institutivos de los líderes políticos de la reforma se examinan a la luz de recientes desarrollos de la economía comportamental, que explicarían el éxito reformista. En la segunda parte sustancial, se fundamenta la hipótesis que las clases altas uruguayas carecen del poder político que detentan en otras sociedades latinoamericanas. Esa debilidad relativa explicaría la baja o nula resistencia a la reforma de sus “perdedores” más notorios. Lecciones para otros esfuerzos reformistas en la región se derivan en la sección final.

**Palabras clave** *reformas, régimen tributario, economía comportamental, economía política, redistribución*

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## **Introduction: the will and the hurdles**

This article explores two sets of factors that are consistent with well established evidence and could explain why Uruguay's tax reform of 2006 succeeded in (re-)introducing a comprehensive and progressive personal income tax, while re-balancing direct and indirect taxes, eliminating inefficient taxes, and strengthening tax enforcement and compliance. It builds on a previous essay on the same topic (Rius, 2012), but explores in greater depth a few of the key facilitating and complicating factors. In particular, it focuses on (i) perception biases that caused a divergence between predictable distributional effects and voters' critical attitudes towards the reforms, and on (ii) the rather shy response of the wealthier sectors of society despite the predictable increases on their tax bills. Though it is clear that Latin American countries differ in many dimensions that are relevant to understand the outcomes of tax reform efforts, this article attempts to show that the Uruguayan experience of the late 2000s can contribute tactical and strategic lessons of value to other reformist endeavors.

Uruguay's progressive tax reform meets several conditions for success that have been identified in the literature. Specifically, it happened in a relatively egalitarian society (at least by Latin American standards), led by a disciplined left-of-center coalition (some political scientists consider it a "party") with an absolute majority in Parliament and a clear blueprint. Although its main objectives did not include raising additional revenue, in the background there was the intent to have more resources available to expand social protection to those most affected by the 2002 crisis. Starting from a comfortable fiscal position, the reformers had some leeway to design a more efficient and equitable regime, while minimizing the number of "losers" (i.e., those that would end up paying more in taxes after the reform than they used to pay before). Moreover, at the time of the reform push the country enjoyed strong growth and a stable macroeconomic environment that made it unnecessary to borrow from the international financial institutions. This meant that opponents could not attribute the reform to external pressures, an argument that has often undermined reformers, especially when they come from the political Left. Instead, the reform could be reasonably depicted as home-grown, which it largely was.

That said, it was not obvious at the time, and it is still awaiting explanation, why there was no serious and enduring challenge from those that were certain or believed that their tax bill was being raised. Section 1 argues that the tax reform was doomed to have a hostile reception from large segments (possibly a majority) of the electorate, despite the administration's high standing in opinion polls and the care taken to present the reform as globally revenue-neutral and beneficial to a large majority of non-rich taxpayers. To make sense of the spread of hostility it is necessary to bring into consideration the literatures on behavioral economics and the behavioral political economy of fiscal policies. These characterize voters/consumers as possessing limited information gathering and processing capacities, and unable to discern the net gains from complex reform packages. We argue that it is also crucial to consider biases in the self-perception of individuals' own position in the income scale, revealed by recent empirical studies. The section then suggests reasons why, despite the negative initial attitude, the implementation of the tax law could move forward without major social upheaval. In particular, we attempt to account for the fact that so far there is no indication that a "movement" will seek a return to the

pre-reform or a similar tax regime, and that there is not such prospect even for the most controversial innovation; namely, the personal income tax.

Section 2 focuses on the response of the richest minorities. It aims to identify a coherent set of reasons why the sectors that actually experienced a negative net change in disposable income did not mount a more determined opposition to the reform. Essentially, it points to the relative weakness of the upper strata in Uruguay, most clearly seen when they are compared with the similar segments of other countries in the region. It is argued that Uruguay's wealthiest sectors are weaker in terms of their capacity to block adverse reforms because (i) they are ideologically and organizationally divided, (ii) they have sparse social and familial inter-linkages with the political elites, allowing the later to enjoy greater autonomy, and (iii) the political parties are highly institutionalized and internally heterogeneous in their social makeup, complicating certain forms of influence from the rich. All these and related factors conspired against a powerful response of the negatively affected and help account for the compliance enjoyed by the reforms. The outlined hypotheses are not tested in this essay, but their plausibility is examined in light of relevant literature and by analyzing a "natural experiment" occurred in the last year and a half and involving another, more limited tax reform.

It is worth noting that, despite the explanations' emphasis on structural features of society, polity and economy that would seem difficult or impossible to change by deliberate intervention, it is nonetheless possible to draw practical lessons for other progressive reformist endeavors. The essay concludes by highlighting some of them.

## **1. Mass public opinion: why the middle class couldn't be won but wasn't lost**

At the time of the public debate on the tax legislation, several actors from different quarters argued that the reform could affect the middle classes disproportionately (or seen to have such effect), creating the risk of some form of political blockage or a post-election reversal (see Rius, 2012; particularly the quotes from those times). These prospects troubled the reformers who anticipated that any success was going to occur despite adverse public opinion that was based on perception rather than fact. Some numbers justify the reformers' concerns, giving rise to a political economy paradox.

Table 1 presents ex-ante estimates of net effects of the complete reform (including changes in direct and indirect taxes) on households' income, by decile, based on static simulations run with 2006 data by the very competent economic analysis unit of the tax administration agency (DGI). The first two columns show that all but the top two deciles could expect a small reduction in their total tax bill, and only the top 10% of households were expected to experience a large enough variation to be discernible (more on this below). While there were prospective losers in all the deciles, they represent less than 10% of households in the first six deciles and they were still an absolute minority in the ninth; only in the top decile was there an absolute majority of about 80% that could expect to pay more taxes after the reform than before. Overall, the whole reform would leave 85% of households better off than they were in the pre-reform situation.

**TABLE 1**  
**BEFORE AND AFTER REFORM TAX BURDEN**  
**AND PERCENTAGE OF WINNERS/LOSERS BY DECILES**

Deciles of households by per capita income	Total tax burden by deciles		Percentage of winners and losers with reform	
	Before reform	After reform	Winners	Losers
1	13,5	10,1	99,33	0,67
2	13,8	10,3	99,36	0,64
3	13,8	10,3	98,96	1,04
4	13,7	10,3	98,26	1,74
5	13,3	10,3	96,98	3,02
6	13,1	10,5	93,62	6,38
7	13,7	11,7	89,08	10,92
8	13,8	12,5	79,99	20,01
9	13,9	14,3	59,13	40,87
10	12,8	17,8	20,66	79,34
<b>All the population</b>	<b>13,4</b>	<b>13,3</b>	<b>83,54</b>	<b>16,46</b>

Source: based on González Amilivia (2007).

Table 2 depicts similar expected outcomes from the substitution of the new *Impuesto a la Renta de las Personas Físicas* (IRPF) for the pre-reform payroll tax (IRP). It shows that on average effective rates could be expected to decline after the reform for households in the first seven deciles, and increase only for the top three.

**TABLE 2**  
**EX-ANTE EFFECTIVE TAX RATE FOR**  
**PERSONAL INCOME TAX VS. ITS PREDECESSOR,**

Deciles of households by per capita income	Ex-ante, per capita effective tax rate (%)	
	RP (pre-reform payroll tax)	IRPF (new, global income tax)
1	0.35	0.29
2	0.95	0.52
3	1.27	0.32
4	1.38	0.52
5	1.65	0.85
6	1.80	1.18
7	1.95	1.71
8	2.41	2.64
9	2.68	4.28
10	2.85	9.07

Source: González-Amilivia (2007)

The paradox starts to take shape when those results are paired with the evidence from public opinion polls conducted contemporaneously with the process of reform and implementation. Table 3 presents such evidence in its simplest form, with regard to the most salient new tax in the reform package –the IRPF.

**TABLE 3**  
**OPINION ABOUT THE IRPF IN THREE NATIONAL SURVEYS**

*(In percentages)*

	Nov-2006	Apr-2007	Apr-2007
In favor	27	23	29
Neutral	11	12	12
Against	47	47	49
K/DA	15	18	10
TOTAL	100	100	100

Source: CIFRA, González Raga y Asociados' website;  
<http://www.cifra.com.uy/novedades.php?idNoticia=17>,  
 accessed January 31st, 2012.

The table shows that almost an absolute majority opposed the personal income tax, before and after the tax legislation was passed in December of 2006, even though it was at the center of a

reform that had a lot more winners than losers, and even when it could be shown to be less burdensome than predecessor taxes for about 70% of households or more. Table 4 confirms that the paradox does not result from misguided forecasts, as the ex-post incidence studies show patterns almost identical to the pre-reform simulations.

**TABLE 4**  
**EX-ANTE EFFECTIVE TAX RATE FOR IRPF VS.**  
**EX-POST NET GAINS FROM ALL TAXES ON INCOME**

Deciles of households % per capita income	Ex-ante, per capita effective tax rate (%)		Ex-post direct taxes over market income (in 2009 %)
	IRPF (encompassing incomes, excl. income tax)	All taxes on pension contrib.	
1	0.29	0.4	
2	0.52	0.9	
3	0.32	1.3	
4	0.52	1.7	
5	0.85	2.0	
6	1.18	2.4	
7	1.71	3.0	
8	2.64	3.9	
9	4.28	5.3	
10	9.07	9.0	

Sources: First column, González-Amilivia (2007), Table A.3;  
second column, Bucheli et al. (2012), Table 5, third column

In summary, the professional judgments anticipated mostly modest gains from the reform for a vast majority of taxpayers, and those expectations were validated by the ex-post incidence studies on the effects of the reforms two years after their enactment. Yet, in opinion surveys the first plurality of taxpayers (almost an absolute majority) was against the leading innovation (the personal income tax), and for all we know they were probably against the reform as a whole. That is the paradoxical picture we try to unravel.

Such unraveling is made easier by insights from behavioral economics, and from an emerging behavioral political economy of fiscal policy (Kahneman, 2011; Thaler and Sunstein, 2008; Slemrod, 2009; Congdon et al., 2011). Among the key we emphasize the following:

- (i) People cannot calculate the direct and indirect effects of complex policy innovations such as a comprehensive tax reform, so their decisions will be based on some combination of rules of thumb and heuristics that cannot be guaranteed to be bias-free
- (ii) Limited cognitive and calculation capacities make people vulnerable to perception biases, in particular regarding their relative social status
- (iii) Humans in their social setting dislike material losses more than they value identical gains; i.e., they suffer from “loss aversion” (a case of the more general problem of “reference-dependent preferences”, Congdon et al., 2011, pp. 35).

We can safely speculate that most voters/taxpayers were unable to put numbers to their expected gains and losses from the reform, even where those calculations were relatively simple. Slemrod (2009), for example, has pointed to evidence that voters often confuse marginal with average tax rates, and we could be almost certain that most Uruguayan taxpayers were unable to figure out the effects of all the taxes that were changed, created, or eliminated in 2006.<sup>1</sup> Moreover, if they had known and understood the calculations behind the figures in Table 1, they might have been inclined not to spend time and money to find out the exact amount they would have to pay in the new vs. the old regimes, or they might have defaulted to a preference for the status-quo resulting from well-documented loss aversion and a zero-centered distribution of their possible personal outcomes.<sup>2</sup>

Yet a second behavioral factor would seem to have had (and may be continue having) deeper consequences. At the time of the reform, professional economists used to find to their surprise that their interlocutors at cocktail parties or family gatherings would point to their own expected increase in the tax bill as proof that the reform had been poorly designed and was going to hurt the middle class (this was often supported by limited or no evidence of the speaker’s position in the social scale, and tended to rest on vague references to new taxes created or new income sources taxed). Reformist players (particularly some at the helm of the Ministry of the Economy and Finance) lamented being unable to convince the middle classes of the reform’s benefits for them, and expected (at least until the 2009 elections) that the criticisms from the middle class would cost them dearly in terms of electoral support. With the benefit of hindsight, we would like to argue that it was probably impossible for the government to win “the battle for the middle class”, but that the combined outcomes do not really represent a defeat, and that they offer lessons for other similar processes.

Let’s go by steps: Cruces et al (2011) have carried out a noteworthy empirical investigation of the biases of self-perception about individuals’ positions in the income scale. Their study is based on a representative sample of the population of Gran Buenos Aires (Argentina). This is convenient because historically and up to the present time, there have been important cultural and socio-economic similarities between that nearby region and Uruguay. We can therefore borrow some of their key insights to interpret the paradox described above.

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<sup>1</sup> It takes trained economists a considerable amount of work to do it for simplified “types” of taxpayers, based on tested methods.

<sup>2</sup> Fernandez and Rodrik (1991) early and elegantly formalized this scenario where the status-quo bias results simply from individuals’ uncertainty about their own specific outcome, even when all the other parameters are common knowledge and the reform is expected to have more winners than losers.

Cruces and his collaborators interviewed about 1.100 residents of the above mentioned region, and asked them the following question: “There are 10 million families in Argentina. Of those 10 million, how many do you think have an income lower than yours?” This question became their indicator for “subjective” self-positioning in the income scale. They also asked for information on actual income, getting interviewees to place their household in one of ten brackets of total income, defined by the actual thresholds among deciles from the latest national living standards surveys (which are supposed to be accurate and unknown to the interviewees). This gave them the individuals’ “objective” position in the income scale, to confront with the subjective or perceived position.

The results from this research are that there are quite large divergences between the subjective and objective position in both extremes of the (objective) scale, with people in the extremes believing they are closer to the median than they really are. On average, for example, people belonging in the first decile tend to feel they are more than three deciles above. The divergence decreases monotonically as one moves towards the median of actual incomes (i.e., top threshold of the fifth decile). From the other end, those in the top decile believe on average that they are part of deciles six or seven, for an average perception bias of -3.15 (i.e., the difference between perceived and actual decile for those at the top is slightly over “minus three deciles”).

How do these results, along with the contributions from behavioral economics and public finance, help us to understand the success of Uruguay’s tax reform of 2006? First, they suggest a context in which it is extremely unlikely that taxpayers will know the precise effects of the reform on their disposable income. If they were reached by the messages from the government conveying the small expected impacts for most taxpayers, they might either have doubts about the source’s intentions or remove the whole issue from their “agenda” given the low significance of the aggregate changes. But then again, they would be moving towards a world of uncertainty (based on cognitive constraints and not intrinsic to any random process) about their individual outcomes. Asked to support changes to tax policies for their greater transparency, efficiency and fairness, those taxpayers might choose the status quo fearing losses that are more dearly felt than similarly-sized gains: even if knowing the majorities will be “winners”, uncertainty about their individual outcome will throw them into a potentially opposing majority.

On top of that, the data from Cruces et al. (2011) shows that, based on average responses, almost the whole population could be thought as placing itself within plus-minus 3,5 deciles from the median (see Table 4), which is about the space of the middle classes in recent empirical research (see for example, the literature reviewed in Hopenhayn, 2010). In other words, not only the discourse based on the preservation and expansion of the middle classes resonates well with the majority of public opinion, but even when the likely consequences of the reforms are laid out in more “objective” terms (without the use of the ambiguous but appealing denomination), almost all the population believes to be part of the aggrieved strata, given the perception biases.

**TABLE 4**  
**OBJECTIVE AND PERCEIVED DECILE BY “OBJECTIVE” DECILE**  
**IN SURVEY OF RESIDENTS OF GRAN BUENOS AIRES, IN CRUCES ET AL. (2011)**

Objective” deciles	Average perceived decile of interviewee: in the respective objective decile	Average bias
1	4.5	3.5
2	4.7	2.7
3	4.5	1.5
4	5.5	1.5
5	5.4	0.4
6	5.4	-0.6
7	5.7	-1.3
8	6.1	-1.9
9	6.3	-2.7
10	6.8	-3.2

Source: Cruces et al. (2011).

The previous are the reasons to assert that “the battle for the middle class” could not have been won by the reformist government. Yet, it does not seem right to describe the situation as a total defeat:

First, the responses of civil society and political actors to the reform were real and vocal for a while, but have gone growingly quiet as time passed. The reform was indeed formally challenged by several lawsuits sponsored by organizations of pension beneficiaries. The Supreme Court initially ruled that the application of the personal income tax to pensions was against the Constitution. However, with the scheduled replacement of one of its members the majority opinion of the Court was going to change. Since in Uruguay constitutional rulings only have effects for those who have filed the suit, the government faced the prospect of having otherwise identical citizens facing different tax treatment, at least until everyone had sued. Neither was it prepared to absorb the loss of revenue that this setback implied. The government then got Parliament to pass new legislation substituting the IRPF on pensions with the newly created IASS, with similar material effects. The new tax was again legally challenged but, with the new composition, the Supreme Court ruled in 2009 that the new tax was not in conflict with the Constitution.

From the opposition and organizations of pension beneficiaries there were announcements of new actions to try to amend the Constitution to establish the prohibition of *any* taxes on pensions. There were even threats of resorting to the mechanism of referendum to repeal the laws, despite the fact that those direct democracy mechanisms cannot be used to question the creation of taxes. Interestingly enough, the majority of pensioners were not among the worst hit by the tax reform (although many of them may be actually higher in the income scale than they

believe they are). What they had that other segments do not have is the necessary cohesion and institutional capacities, built on past victories (pay-as-you-go pensions were indexed to the average wage index in 1989, after a popular initiative supported that measure in the polls) and the electoral power of a sizeable constituency with unified interests.

Second, the reform was not actively resisted by trade unions or other economically active groups when it started to have material effects in July 2007. This suggests that the expectations derived from ex-ante simulations were largely validated and the taxpayers could see them reflected in their paychecks (but there is an additional behavioral interpretation proposed below). The modest positive effects experienced by the majority of taxpayers might not have been enough to make them happier but certainly did not cause those majorities to feel abused. Third, and most important, had there been deeper and cumulative resentment with excessive burdens or injustices contained in the new regime, it would have been much more difficult for the governing coalition to be re-elected with an absolute majority again in 2009. In this sense it is worth recalling that only a few months before the election the pensioners were still fighting the tax(es) in the Supreme Court, and even this was not enough for any opposition candidate or party to make substantial gains on a platform prioritizing the reversal of the reforms.

At least for these three facts, it can be said that “the battle for the middle class” that was essentially impossible to win was not lost either. For other reformist processes, it might be useful to enumerate factors that would seem to have avoided outright failure.

- (a) As soon as the Law was passed, the government through the tax collection agency (DGI) implemented a broad and systematic national information campaign, not just broadcasting slogans or abstract arguments but setting up advisory services throughout the country that allowed taxpayers to find out exactly how much in taxes they were going to pay in the new regime. This was a direct and eventually effective response to some of the cognitive limitations that behavioral economics emphasizes, and to the very specific challenges posed by a complex set of fiscal policy changes.
- (b) The economy was growing rapidly, and taxpayers are known to have difficulties discerning between causes of monetary changes when they operate simultaneously and are of varied sign and size. It cannot be discarded that rapid growth obscured the specific effects of the reform for at least some skeptics, and perhaps also for some of the modestly losing taxpayers. Strong growth may have had a reinforcing confounding effect, on top of the effect of evidence and information.
- (c) Many taxpayers may just have confirmed in July 2007 (intuitively rather than by comparing well-calculated net outcomes) that the effects of the reform on their situation were in any case not significant enough to worry. The conclusion would not have been the result of complex calculations but rather reflect the confirmation that they were receiving “about similar income” and that others would be experiencing the same since life went on for them and their employers/peers/clients without any disruptions. We do not know for sure whether it played a role, but consumers have been found to worry more about relative than absolute changes in actual or achievable consumption (Duesenberry, 1949; Graham, 2005; Frank, 2007). If those “changes” are small and in any case shared

by many of a similar status, the relative foundation of happiness and psychological well-being might have played in favor of the lack of mass opposition.

- (d) It cannot be discarded either that some who felt a decline in their net income may have acquiesced to the reform based on “fairness” considerations; experiments run by behavioral economists have shown that fairness plays a more significant role in many individuals’ decisions than it is generally acknowledged in mainstream microeconomics. The reform came after a left-of-center coalition won a national election for the first time in the country’s history, and progressive redistribution was in the platform of a political organization that only could have received more than 50 per cent of the vote with some support from relatively wealthy voters (more on this below).

We have provided no empirical test of these hypotheses, but they are congruent with the empirical data presented above; if they are considered plausible, they have original policy implications that are discussed in the last section. Before that, we focus on the response to the reforms from those who were certain to pay more taxes with it.

## **2. The upper strata: divided, disorganized and powerless?**

The success of the Frente Amplio’s government in passing the tax reform of 2006 raises the issue of why it elicited only a weak public response and no meaningful nor lasting opposition from the social segments that were most harmed by it (that is, those minority but influential segments at the top of the income and wealth scales, that saw their tax burden increase as a consequence). As illustrated in the previous section, Uruguay has a rich history of collective action to oppose economic reforms through institutional channels; as will be shown below, that history was far from over at the time of the 2006 reform. Why then did the wealthy not try to stop the 2006 tax reform through formal political mechanisms?

Moreover, institutionalized collective action is not the only political alternative available to the richest strata of society. Typically, the upper classes can influence the policy process through various informal means (arguably: influencing the media to cast a negative shadow on the proposed reforms or the reformers, threatening with withdrawing support and financial contributions in the next election, etc.). However, if the means were tried, the force with which they operated was far from insurmountable for the reformers, and in the end it was ineffective to stop the legislation from being passed and the reforms from being implemented.

As it was shown, those negatively affected by the reform could be anticipated to be a minority of the population (less than 20%), but they were not *any* minority.<sup>3</sup> As a group, the harmed by the reform comprises households at the top of the income scale, which have a strong voice and multiple direct and indirect channels to influence the policy making and the political processes.

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<sup>3</sup> The estimates available of proportions of winners and losers come from the ex-ante simulations, since there are no panel data or other retrospective records to actually identify unambiguously those that faced an increased vs. a reduced tax burden. The ex-ante simulations gain validity from comparing some of their results with some ex-post incidence analyses (such as, e.g., those in Bucheli et al., 2012).

In addition to their typical clout, in the instance they could have been aided by the widespread view that the reform was contrary to the interests of the middle classes, and by the biases in perception that inflate the ranks of the latter. In those circumstances, it might have been possible to put together a winning coalition. In fact, Latin America's experience shows that, without the richer segments' acquiescence, even limited progressive reforms do stall or die (that has been the experience of Guatemala, but also of Costa Rica and Chile; see Gómez Sabaini, 2006; Fairfield, 2010; and ICEFI, 2012). So, why is that the affected sectors did not react more emphatically and effectively in Uruguay?

The paper lays out below a coherent set of hypotheses to answer the previous questions, and provides some "soft" evidence to argue that they are plausible, building on previous work by several authors (Fairfield, 2010; Mahon, 2004; Arnson and Bergman, 2012, and the contributions summarized there; and Rius, 2012). The intended contribution to that literature would follow from the addition of another case study (here, of *a successful progressive reform*), the attention paid to social, political and economic factors, and from exploring the potential of a behavioral economics approach to the political economy of reforms.

In the literature, the upper strata are assumed to have some form of power to condition the success of progressive reforms, but the foundations of such power, and specifically how that power is exerted, are not always spelled out. Also, in some of the studies the business sector is taken to be an encompassing and complex entity, including its visible organizations (e.g., industry-specific business associations), but also the corporations and smaller firms that are more or less represented by them, and (mostly implicitly) also the households classified in the top percentiles of the wealth or income distributions. We try to be more specific about those terms. While the previous section dealt essentially with richer households and their role in broader "mass" opinion, the following pages will examine the political influence of "business" understood (and referred to) as *organized and formal pressure groups as well as more informal lobbying activity sponsored or undertaken by firms*. When we speak of the upper classes, economic elites, upper segments of society, or "the rich", we envision *individuals with the greatest wealth and incomes*, who may or may not be active in business organizations, or feel represented by them or by corporate leaders. Our hypotheses are largely informed by the Uruguayan case, but take into account some comparative evidence.

We propose that the reform of 2006 succeeded because Uruguay has an ideologically and organizationally divided upper class that failed to overcome the collective action challenges of confronting a majority government. The level of fragmentation of the upper strata is thought to be a long-lasting feature of socio-economic structure that is logically related to —although it does not require nor is determined by— a low density of personal and family inter-linkages between economic and political elites. The latter does contribute to the fact that (at least in normal times) the economic and the political elites are largely separate categories, and to the relatively high autonomy from business interests enjoyed by political actors. On the side of the political system, we want to argue that a highly institutionalized and catch-all party system prevented the upper strata from obstructing the reforms.<sup>4</sup> In a way, our analysis of the response (or lack thereof) of

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<sup>4</sup> More generally, we hypothesize, but do not attempt to prove, that rather than causing the political phenomena, the more permanent levels of economic inequality (e.g., those that are revealed by averages and relatively stable positions in cross-country rankings) actually *result* from (also long-lasting)

the wealthier and of business as a collective actor has a lot in common with Fairfield's (2010), particularly on the sources and role of "instrumental power", although we might expect the sources of such power to be more stable than suggested in that work. In broad terms, Uruguay could provide a fitting counter-example to Chile.

Our characterization of the formation of Uruguay's upper segments comes largely from Real de Azúa (1969). He portrays the emergence of differentiated upper classes in the XIXth century, and their trajectory up until the late 1960s, in terms that shed light on the possible causal channels that connect economic inequalities with behaviors of the elites. He describes factors that account for the lack of ideological cohesion among the elites, and the relative disconnect between the economic and political upper classes. Regarding the former, he highlights the effects of a weak religiosity founded in an adherence to Enlightenment values among the groups of Hispanic settlers that found their livelihoods on the Easter side of the De la Plata River. The weak influence of Catholicism would have distinguished the social milieu in Uruguay from that in neighboring countries (Real de Azúa mentions Argentina; we would add Chile).<sup>5</sup>

Later immigration flows from a variety of economic and cultural traditions, and a relatively upwardly mobile society, did not contribute much to the unification of ideas and values, or the elites' sense of belonging to a single social category. Mobility, in turn, would have derived from the nature of the rich's assets and the political upheaval that characterized the country for the half century since independence: internal and international armed conflicts periodically depleted "traditional" rural wealth (through their effect on stocks of cattle and other rural property), and the ascent of the local mercantile elites was checked since colonial times by the uneven competition between Montevideo and Buenos Aires to become main hubs of regional trading networks.

Well into the XXth century, the absence of a concentrated and ideologically unified supply of primary and secondary education for the elites, and the singular presence of the State and the middle classes in the hegemonic institution of tertiary education (the Universidad de la República), prevented the economic upper echelons from acquiring ideological cohesion through shared socialization, which is a key asset in coordinating collective action.<sup>6</sup> With such lack of unity in the domain of ideas, the social dynamics did not promote a denser network of personal and familial ties to connect different segments of the upper classes more tightly. Religious, ideological, ethnic, and partisan cleavages cut across economic categories with similar or

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characteristics of the upper sectors and the political system (e.g., their ideological cohesion, the depth of the linkages between economic and political elites, and the relative autonomy of institutionalized and catch-all parties).

<sup>5</sup> "El Río de la Plata y su virreinato fueron hijos de la España borbónica e "ilustrada", una filiación que los aleja mucho más que al resto del "reino de Indias" de las pautas de conducta y los valores de la Contrarreforma. Y esta excepcionalidad se acentúa grandemente en las tierras en que se desplegaría el Uruguay si se la compara con las huellas culturales ya impresas en lo que sería la Argentina. El cotejo es revelador no sólo con la zona centronorte, firmemente tradicional (aun hasta hoy), sino incluso con Santa Fe y con Buenos Aires, mucho más próximas, por múltiples factores, a los trazos que nos caracterizaron (Real de Azúa, 1969; p. 11)

<sup>6</sup> "Nuestro sistema educacional no concurre espontáneamente a robustecer vínculos endogrupales de un sector superior. Piénsese, por contraste, en la influencia de las "public schools" inglesas o en las universidades de la "Ivy League" estadounidense." (Real de Azúa, 1969, p.40)

sometimes stronger force than material interest, and those do not make intermarriage within a broader unified elite any easier. This other lack of cohesion among sub-sections of the economic elites impacts directly on the capacity for coordination, when most of the economic entities (companies, economic groups) are family-owned and family-run.

The import given here to an account of Uruguay's upper classes written more than forty years ago could be questionable. However, there are at least two justifications for taking it quite seriously. First, research on the social configuration and behavior of the elites has not been abundant lately, but the few studies available have not contradicted Real de Azúa's.<sup>7</sup> Moreover, even if one recognizes what has happened since 1969—in a nutshell, the collapse of the ISI model, the military regime of 1973-1985, and the new democracy cum globalization since 1985—must have had significant social impacts, the nature of the factors highlighted by Real de Azúa are of the kind that have lasting effects and change at almost glacial speed.<sup>8</sup>

Even this sketchy characterization of the upper echelons of economic power could explain the absence of any cross-sector, second-level organization representative of the broader “business” interests. This is despite the existence of sector organizations of reasonably high coverage of the respective constituencies. Perhaps the stronger are found in the large rural property and production, with two historically distinct but frequently collaborating associations. Close in lobbying power comes the financial sector (in recent times populated exclusively by subsidiaries of foreign banks), and somewhat behind the manufacturing and the mercantile sectors (with distinct organizations for the domestic and international trade branches).<sup>9</sup> Attempts to aggregate

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<sup>7</sup> Among these, Stolovich et al (1987) could be thought to detect a greater concentration of power and more powerful elites, but that is largely an effect of the Marxian approach; it will be shown below that their observations can explain a counter example to the 2006 tax reform. Zurbriggen (2005), and the works cited there, by Carlos Filgueira, Gerardo Caetano and Jorge Lanzaro, mostly coincide with Real De Azúa on the limited power of business over the policy process, and the relative autonomy of the political elites. A classical contrasting view to Real de Azúa's, but one that needs qualifications from a comparative perspective and that is based on weaker evidence, is that of another “founding father” of Uruguayan sociology, Aldo Solari. He had claimed (Solari, 1956) that “Las clases altas, la burguesía propiamente dicha, es una clase altamente organizada y con una fuerte conciencia de su existencia. Esa organización se ha plasmado en una multitud de instituciones de las cuales aquí se indican las fundamentales. Vale la pena señalar, además, que esa organización puede rastrearse hasta la época de la Colonia. *Con esto no queremos decir que la movilidad vertical no haya existido en el Uruguay y que las mismas familias continúen a través de generaciones ocupando la cúspide de la pirámide social, como ocurre con bastante intensidad en algunos países americanos.* (...) Es cierto que la división de las clases altas en rurales y urbanas, y dentro de estas en comerciantes, industriales, hacen que no con respecto a todos los problemas las opiniones de la clase y de sus organismos sean unánimes; pero tal cosa se refiere a problemas que no afectan a la clase social como tal sino simplemente a determinados grupos de intereses que, dentro de ciertos límites, pueden ser contrapuestos.” (pp. 260-62, emphasis added)

<sup>8</sup> It is probably the case that new economic groups coexist with the old. For example, that seems to be the case in the agriculture and livestock industry. Yet, the persistence of the old (and very old, by the country's relatively short history) can be gauged from the relative influence still enjoyed (see below).

<sup>9</sup> Emerging crucial actors in the business sector in Uruguay are the large multinationals responsible for recent major investments (e.g., in the pulp and paper industry), but their tax burden is *negotiated* with the government within the framework of a highly discretionary investment promotion regime that allows them to claim almost a full freeze of their tax status at the time of signing the “investment contract”. Many of the recent foreign direct investments are based on tax-free zones, all of what makes them relatively

and synthesize demands and develop coordinated action have not gone very far except under exceptional circumstances (such as the transition from military rule to democracy in the 1980s). The large size of bi-partite and tri-partite bodies in the local institutional landscape (that is, workers-employers and workers-employers-State) often reflects attempts to create enough seats to accommodate a plural business class whose members do not feel represented by a single or a few high-level associations.<sup>10</sup> In brief, the inexistence of a single organization representative of the larger and economically most significant business interests is not by itself the reason that explains weak resistance to the tax reform; instead, it symbolizes the lack of common views and the organizational power among the economic elites to pose a serious threat to a determined reformist government with enough legislative backing.<sup>11</sup>

The other face of the coin of the division and disorganization discussed above is a political system that has exhibited high degrees of autonomy from the economic powers. But that autonomy cannot be fully understood without highlighting the comparatively high degree of institutionalization of the party system, as well as the mixed social makeup of the major political forces. In fact, Uruguayan parties record some of the greatest longevity and vote share stability in Latin America (Coppedge, 2001; Luna, 2007). They have been characterized as fractionalized but not to a level much different from the parties in other stable democracies, and capable of acting in a reasonably disciplined manner when in control of the Executive or in the opposition (González, 1991).

In terms of their electoral (and financial) supports, none of them can be identified clearly as the party of the wealthy (as much as no party can be credibly identified as the party of the working classes; Real de Azúa, 1969; González, 1991; Luna, 2007). This means first that in the 2004 election there were segments of the upper classes prepared to endorse the policy program put forward by the Left, so they were aware of the impending tax changes and took their potential adverse outcomes as the price of other valued reforms expected from the new government. In the language of financial analysts, many wealthier segments had already “discounted” the reforms. Second, the catch-all nature of the parties makes it harder for any opposition fraction to pick up the flag of an anti-reform agenda that could easily be construed as the agenda of the rich.

A last combination of factors regarding the political representation of the richer strata involves the degree of party institutionalization and the effectiveness of campaign financing as a tool of instrumental power. In fact, the country lacks effective financing regulation to curb at least overwhelming political influence of the better-off, but confronted with institutionalized catch-all parties that tend to have heterogeneous agendas, the wealthy have chosen to hedge their losses

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uninterested in the business taxations issues raised by the 2006 reform (although the reform and the investment promotion regime are not disconnected policies, and nor is their “political economy”).

<sup>10</sup> That is the case, for example, of the Consejo Superior Tripartito, that has government, unions and business representatives to oversee tri-partite collective contract negotiations, and has six seats for the each of the “social” actors (a single national labor confederation occupies the six seats for workers), to accommodate the diversity of views from the private sector on matters of “industrial relations”.

<sup>11</sup> Indeed, some could argue that the reform benefitted the business sector by reducing the tax on corporate incomes (from 30% of the pre-reform IRA and IRIC to the 25% of the new IRAE). However, this would miss the point as the consolidated 25% rate was then “tied” to the marginal rate on the top IRPF bracket, to prevent tax arbitrage, and was then linked for the longer term to the debate on progressivity and the fair level of redistribution.

rather than betting to win: they have traditionally spread their contributions on more than one competing force, and this has weakened another channel through which they could have achieved something like a high-level veto power. This is a far cry from situations where actual contributions, or promises of those, suffice to motivate legislators to leave their political party and create another political force capable of competing for greater prizes in the next election (to some extent, this describes a frequent phenomenon in, e.g., Guatemala). In brief, in Uruguay the political and party system had long-lasting features that are detrimental to the influence that the better-off might want to have on the contents of a tax reform. This allows a party with the necessary electoral backing to introduce innovations that in other contexts would have died in Parliament or outside.

### *A natural counter-factual*

It is a fortunate circumstance that there have been recent developments in Uruguay that shape almost a natural experiment on the role of ideological and organizational cohesion in addressing collective action challenges. On 29 November 2011, Parliament approved the law that creates the *Impuesto a la Concentración de Inmuebles Rurales* (or ICIR).<sup>12</sup> The tax was set to be paid by individuals, households or companies owning more than 2.000 hectares (in productivity-adjusted units), and specified fixed yearly amounts (in inflation-adjusted accounting units) per hectare, with the amount growing through four brackets of total area owned.<sup>13</sup> The proceeds were going to be administered by local governments (*intendencias municipales*) and to be earmarked for investments in local roads, and roads maintenance and improvement in rural areas.

While land assets are already taxed both at the municipal level (*contribución inmobiliaria*) and at the national level (*impuesto al patrimonio*), the ICIR was meant to discourage the *concentration* of land ownership. The phenomenon appears to be taking place in parallel with the boom of agriculture commodity exports and the establishment of large pulp and paper plants, driven by acquisitions by corporations, investment funds and wealthy Argentinean and Brazilian planters (Errea et al, 2011). Unlike other countries in Latin America, Uruguay does not face the pressure of forcibly displaced and/or large and rapidly growing rural population. Yet, the political Left has traditionally questioned the uneven distribution of land and sees its further concentration as much as a cause of further expulsion of rural population as a way of capturing rents from the resource-based export boom (in the past, it used to see it as source of economic inefficiency; Instituto de Economía, 1970).

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<sup>12</sup> Law Number 18.876. It took the government twelve months to issue the decree that lays down the specific rules for the administration of the tax, which is symptomatic of internal disagreements that exist over this tax among members of the left-of-center coalition (see, e.g., Brecha Digital, 7 September 2012, <http://brecha.com.uy/index.php/politica-uruguay/515-teoria-de-la-interpretacion>, accessed 26 March 2013).

<sup>13</sup> The owners of (productivity adjusted) 2.000 to 5.000 hectares must pay 67 Unidades Indexadas (UIs) per hectare, those owning 5.000 to 10.000 must pay 100 UIs, and those owning more than 10.000 will pay 135 UIs per hectare. September 30<sup>th</sup>, 2012, the UI was 2,4570, and the US\$ was 20.988 pesos per US\$, so the amounts per hectare were equivalent to US\$ 7,84; US\$ 11,7; and US\$ 15,80, respectively. The law defines a set of family ties and firm linkages that make the group a taxable entity, to prevent the avoidance of the tax through nominal proprietorship.

Unlike the IRAE and IRPF, the ICIR targeted the assets of one segment of the upper strata. Even considering that there have been changes in the property structure of Uruguay's productive land, the traditional large land holders and foreign entrepreneurs and companies clearly shared an interest in stopping the tax from taking effect.<sup>14</sup> Among the affected is a sub-segment of the economic elites –the medium and large land holders'—that has a history of lobbying the public sector for (or against) measures that impact on their profitability. The cattle-growers and other owners and managers of large rural concerns have for more than a century organized in two major sector associations, each one of them with a long tradition of unified thought and action. Although the Asociación Rural has traditionally represented wealthier *estancieros*, its actions have often been coordinated with the less elitist Federación Rural, whenever there have been policy innovations that they have perceived as threats to the whole sector.

The reactions against the ICIR did not take much time to emerge. Some of the responses are illustrative of the new makeup of the rural interests: three of the early lawsuits were brought up by large companies that have diversified and non-traditional investments in which land has a variety of functions.<sup>15</sup> Soon after its approval in Parliament, more traditional *ruralistas* had set up a basic organizational structure to promote the challenge of the new tax before the Supreme Court, on constitutional grounds. The two organizations encouraged and provided legal support to individuals willing to sue. As of November 20<sup>th</sup>, 2012, the Federación Rural was actively advising its members to comply with the law and decree (just approved) but to file lawsuits, while organizing public events with legal experts to question the legitimacy of the tax, and issuing public statements attacking it.<sup>16</sup> The Supreme Court ruled later in the year that the tax was outside the admissible by the Constitution, as its linkage to local governments' revenue and expenditure contravenes their fiscal autonomy. The government is set to replace it with a similar tax that does not deviate from constitutional principles.

The rapid and emphatic response of the *ruralistas* and their organizations to the tax marked a clear difference with respect to what happened after the approval of the major reform of 2006. In no minor part, the greater cohesion of the smaller affected group, and of its representative organizations, had a role in accounting for that difference, which supports the hypothesis about cohesion and veto capacity.

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<sup>14</sup> The incentives for collective action were not identical, though, as some foreign investors have their land covered by major industrial investment projects that have negotiated tax exemptions derived from size-specific clauses of the investment promotion regime. Those exemptions are contained in Investor-Government contracts that were thought to protect the firms from policy innovations, which eventually happened.

<sup>15</sup> The first lawsuit was filed by one of the largest rice producing companies, which owns land for its plantations. The second came from the Chilean-Swedish consortium Montes del Plata, that has been hoarding land for the tree plantations that will feed its large pulp and paper project in the West of the country. The third litigant was a group best known for running the ferries system between Argentina and Uruguay but which also owns a large dairy company. The second and third lawsuits were later dropped by the complainants, which happen to have multiple and major dealings with the government for their various business dealings.

<sup>16</sup> <http://www.elpais.com.uy/121120/ultmo-676895/ultimomomento/federacion-rural-recomienda-impugnar-impuesto-a-la-tierra/>, and <http://www.federacionrural.org.uy/> accessed November 24<sup>th</sup>, 2012.

Those who have explored the interconnections of personal and business relationships of the economic elites (Stolovich et al., 1987) have argued that development of familial ties are one of the mechanisms of creation or consolidation of economic groups. The issue deserves detailed and careful analysis of evidence that is not readily available, but anecdotal evidence suggests that in this dimension Uruguayan elites are also less “cohesive” than those of other neighbor countries (e.g., Chile). This could also be associated with the more limited sectoral diversification of the mapped economic groups that have their origin and key node in agriculture-related businesses (Stolovich et al, 1987, pp.46-48). The mobilization of the *ruralistas* in 2012, compared to the acquiescence of larger affected groups in 2006, could perhaps result also from a denser set of personal-business relationships.

Finally, the ICIR has generated criticisms but the political system has largely avoided getting drawn into a debate that can be easily portrayed as one between a fairness-concerned government and a reduced group of owners of large (and huge) tracts of land. This is not the situation one expects to find where there are politicians or parties open to the possibility of endorsing a measure in exchange for generous campaign contributions, and is very much in line with the parties’ catch-all electoral base.

### **3. Some tactical lessons**

In the previous pages we have presented evidence that helps understand why the progressive and comprehensive tax reform of 2006 in Uruguay did not fail, despite elites’ discomfort and biased perceptions and expectations of a quite large constituency. Some of the factors thought to account for the widespread acquiescence can be considered historical accidents, and several others point to social, political and economic structures that cannot be easily changed by deliberate political action (not in the short-term, anyway). However, that does not mean that the analysis carried out cannot provide valuable insights for those attempting progressive tax reforms in similar contexts.

As argued in the companion article, the bounded rationality of taxpayers and policymakers seems to demand a careful administration of political capital and communications capacities to succeed. For example, where agents have difficulties in computing net effects of complex reforms, signals become quite important. It will be easier to believe that a government is committed to tax fairness if it is fighting evasion by the rich as much as it punishes evasion by the middle and lower social strata, while suspicions that it is too benevolent with the wealthy may extend to other aspects of the ruled-ruler relationship (for example, when the ruler explains the expected effects of the reforms).

The successful experience of progressive reform in Uruguay shows that perception biases make some battles unwinnable, but this does not mean they should be avoided, or that the supply of useful and understandable information does not matter. Informing taxpayers in very personal ways about effects of the new law on their purchasing capacity appears to have been a most valuable investment in generating a climate that encouraged compliance. In an extension of their survey Cruces et al. (2011) inform some of their subjects their real position in the national income scale, while others are not given such information. Those that are informed of a position

lower than they thought they had exhibit greater support for redistributive policies than those that are not offered the information. This speaks to the value of information, even if many may choose not to listen to it or doubt the purposes of a government that offers such assistance.

Information is also important because there are taxpayers that pay and accept taxes out of a sentiment of fairness and duty. Moreover, if as some authors have come to believe (Duesenberry, 1949; Frank, 2007), consumers care more about relative than absolute consumption, then being able to make sense of comparisons with their reference group or relevant role models is quite important to taxpayers. A reform that has carefully considered and protected horizontal equity should be more easily accepted if that information is communicated effectively.

Turning to the strengths and weaknesses of the upper classes, despite their deep historical roots they can still point to factors that the reformers may be able to influence. For instance, the fact that socially diverse (catch-all) parties helped get the reform passed and consolidated, could suggest that forming a diverse progressive reform coalition that includes well-known, economically successful individuals and organizations may help neutralize discourses that construe it as a socially divisive innovation, or a disincentive to seek economic success.

Another contributing factor to the success of the reform seems to have been the absence of a unified opposing voice from the richest tiers of the wealth scale. The structural factor was somehow exploited strategically by the government, when setting up an early “public consultation” on the principles of the tax reform (undertaken despite the fact it was not required by legislation). The reformers would claim that the mechanism allowed them to have a transparent discussion on general principles, forcing those expecting special treatment to justify it publicly.<sup>17</sup> This probably did not save the reformers from having to listen to some of those demands afterwards, but they may have been less frequent than in a different scenario, and somewhat weakened by the transparency principle established by the government.

The reform of the Investment Promotion Regime was timed and specifically conceived to (further) weaken the resistance from the economic interest groups. In fact, the “public consultation” already saw contributors arguing their case on the basis of jobs created/lost, or contribution to growth or export income. These do not mix well with the reform of taxes on individuals and varied sources of income. The approach of the government was to split negotiations in two, actually aligning each with some but not all the key principles of the overarching reform package: while efficiency and equity were key issues around the 2006 law, promotion of investment was negotiated in another table, around the 2007 decree that re-regulated the fiscal incentives regime to promote investments. Thus, when individuals and firms (and consumption) are taxed according to their incomes/revenues and almost nothing else (except principles of equity, efficiency, and practical feasibility), demands justified on jobs created or to be protected in a specific sector are out of place. The separation also allows the second table to discuss some “conditionality” on the benefits granted. It can be reasonably assumed that separate tables, and transparency and universalism work best with divided upper strata, but should not be prematurely discarded with more cohesive elites.

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<sup>17</sup> Interviews with senior officials in the reform team at the Ministry of Finance. Various comments in this section based on those.

In brief, recognizing the real capacities of humans and their organizations, and wondering about the socio-political channels that translate inequalities in wealth and incomes into effective powers in the policy arena, has opened an agenda that would be most profitably explored through systematic comparative analysis. The addition of one case to a small emerging literature demonstrates the richness of the comparative approach, and speaks about possibilities of refining the set of transportable generalizations.

#### **4. Concluding comments**

In 2006, Uruguay succeeded in introducing a broad and progressive tax reform because the government had the required support in Parliament, managed to overcome the single legal challenge from pension beneficiaries, was not confronted by the moderately hostile (and “inflated”) middle classes, nor by the upper classes which are historically weak and lack cohesiveness and leadership. Adept, but perhaps only partly intentional management of signals sent to perception-biased voters played an important role in avoiding an outright defeat in the “battle for the middle class”. Information offered transparently and accessibly, and the simultaneous strengthening of a tax administration agency that does not seem afraid of big players, convey some of the messages needed to turn moderate disagreement into acquiescence.

The reform has confirmed the expected distributive outcomes and almost six years after entering into force it seems very unlikely that it will be repealed by an ideologically contrarian government. The recent failure to sustain a new tax on concentration of land property has to be interpreted as partial confirmation that the broader-reaching reform profited from hard collective action problems faced by the wealthier, as the latter lack the cohesion, organization, and ideological affinity of the rural land-owners that brought down the latest tax. The government’s own internal disagreements may have helped reach that outcome, at least if technical mistakes are interpreted as a reflection of a hastily designed project that did not benefit from broader constructive review within the Executive.

While the structural weakness of the economic elites and upper strata, and their democratic convictions, cannot be easily replicated elsewhere, the case suggests that progressive reforms are more likely to succeed if a broad and diverse social coalition can be built to support it, including some visibly successful individuals and business organizations; and if the personal and corporate income design issues can be handled separately from the economic stimulus measures.

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